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A Study on the Significance of Risk Management in Banking Sector

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ABSTRACT

Risk Management refers to the Practice of identifying potential risk in advance, analysing them and taking precautionary measures to reduce the risk. Risk arises from uncertainty. It can be considered as an unplanned event with financial consequences resulting in loss or reduced earnings. The most important challenge faced by the banks today is the challenge of understanding and managing the risk. The present paper tries to understand the various types of risks faced by the bank and how the risk can be controlled. It also examines the process of risk management and the different techniques adopted by the banking industry. The study which is conceptual in nature and is based upon data collected from secondary sources. It can be concluded that the success of the organization will be depending upon how efficiently the enterprise takes care of the entire risk management system. It ensures that the risks are consciously taken with full knowledge, clear purpose and understanding -so that it can be measured and mitigated.

Key Words : Risk Management, Uncertainty, Financial Consequences, Earnings, Techniques,

INTRODUCTION

The Indian banking sector is making great progression in terms of eminence, quantity, growth and diversification and is keeping up with the updated technology, ability, stability and thrust of a financial system. Liberalization, Privatization and Globalization have opened up new methods of business transaction where risk level is very high. Risk arises from uncertainty. It can be considered as an unplanned event with economic consequences resulting in loss or reduced earnings. In Banks and other financial institutions risk is considered to be the most important factor of earnings. Risk is a predominant factor in the achievement of goals and in the overall success of an organisation. Risk assessment forms the foundation of an effective enterprise risk management program. Risk assessment is a systematic process for identifying and evaluating events that could affect the achievement of objectives positively or negatively.

REVIEW OF LITERATURE

1.Dr. Khalil Elian Abdelrahim (2013), in his study ‘ Effectiveness of Credit Risk Management of Saudi Banks in the Light of Global Financial Crisis: Qualitative Study ‘ analysed the features of credit risk management, determinants of effectiveness of credit risk management and the most serious challenges facing the effectiveness of credit risk management of Saudi Banks. CAMEL model was used for analyzing the effectiveness of credit risk management. He has found out that major challenges of effectiveness of credit risk management are low quality of assets, inadequate training, weak

corporate governance, lack of credit diversification, granting of credit ceiling exceeding customer capacity of repayment absence of risk premium on risky loans, absence of serious analysis of customer's financial position, corruption of some credit officers, priority of profit at expense of credit safety. He has recommended that Saudi Banks should have an overall comprehensive strategy of credit risk management and should adopt sophisticated mitigating techniques of credit risk. It is advised to strengthen the role of credit risk committee and should be ready to implement Base III Accord by the year 2015.

2. Corporate Governance and Risk Management in the Banking Sector of Ghana was conducted by Seyram Pearl- Kumesh, Yakubu Awadu Sare and Bawnah Bernard to examine the degree to which banks in Ghana use risk management practices and corporate governance in dealing with different types of risk. Bank accepts risk in order to earn profits. Risk management is crucial in case of banks as risk is inherent in the banking activities as they accept deposits and lend them out or invests these funds in other investment portfolios; they face risk that other organization would not face. They have found out that the major risk management process identified by the selected six banks in efficient corporate governance and risk management includes understanding of risk and risk management, risk identification, risk assessment and analysis, risk monitoring and controlling system. The major finding of the study is that almost all the selected banks believe that, Bard of Directors is not directly responsible for risk management. The important types of risks are credit risk, operating risk, solvency risk, interest rate risk and liquidity risk. They have also found out that Board of Directors do not assume direct responsibility for risk management, but its governance activities can contribute significantly to effective risk management.

3. Credit Risk Management in Indian Commercial Banks was undertaken by Ms. Asha Singh explains the credit risk management which includes identification, measurement, monitoring and control of the credit risk exposures. The effective management of credit risk is a critical component of competitive risk management and essential for the long term accomplishment of a banking organization. The major objectives of credit risk management are to evolve an integrated frame work for charting various types of loans and advances and determine implications on quality of credit and risk. Another objective is to evolve and refine analytical tools to assess risk profiles for ensuring healthy portfolios and guarding against sickness. Risk based pricing, covenants, credit insurance and credit derivatives, diversification and deposit insurance are the various methods to mitigate credit risk. She has concluded that credit risk management policy of the bank dictates the credit risk strategy. The different policies spell out the target markets, risk acceptance/ avoidance level, risk tolerance limits, credit risk management, monitoring and controlling mechanism.

4. Credit risk management in Indian banks was conducted by Patil Jaykar Bhaskar (2014) discussed about various tools and techniques to manage credit risk. He has observed that levels of authority for credit approval help to guarantee that decisions are prudent and are made within defined parameters. Organisations should have procedures in place to govern the collection of principal , interest and other charges in accordance with established terms of repayment He has recommended that some kind of mechanism to address the issue of nonperforming loans should also exist for enforcing a creditor's rights in case of loss loans. The various techniques of credit risk management are exposure ceilings, Review/ Renewal, Risk rating model, risk based scientific pricing, portfolio management and loan review mechanism. He has recommended that as risk is
inevitable in business ,the organization must strike a tradeoff between the risk and the profit. The objective of risk management is not to prohibit or prevent risk taking activity, but to ensure that the risks are consciously taken with full knowledge, clear purpose and understanding so that it can be measured and mitigated.

5. Risk management in Banking Sector –An empirical study was undertaken by Thirupathi Kanchy & M. Manoj Kumar (2013). They have made an effort to identify the risks faced by the banking industry and the process of risk management .It also examines the various techniques adopted by banking

industry for risk management. They have concluded that the existence of an organization depends mainly on its capabilities to anticipate and prepare for the change.

6. “The Relationship between Credit Risk Management and Profitability among the commercial Banks in Kenya” was the article authored by Josiah Aduda, James Gitonga (2011). Credit risk management in banks has become more significant not only because of the series of financial crisis that the world has experienced in the recent past, but also the introduction of Basel II Accord. The objective of the study was to set up the relationship between credit risk management and profitability in commercial banks in Kenya. Ratio Analysis and Regression Analysis are the important tools used by the Researcher. They have used Return on Equity as the indicator of the profitability in the regression analysis. The study proves that there is a relationship between credit management and profitability. Majority of the respondents are of the opinion that credit management principles are applicable in the banking institutions. They have mentioned about the six Cs of credit management which include Character, Capability, Context, Credibility, Collateral and Conditions. They have concluded that there is a relationship between credit risk management and profitability in commercial banks in Sweden.

STATEMENT OF THE PROBLEM

Analysis of Risk and its management has got much importance in the Banking Industry. The most important challenge faced by the banking industry today is the challenge of understanding and managing the risk. The very nature of the banking business is having the threat of risk imbibed in it. Banks’ main role is intermediation between those having resources and those requiring resources. For management of risk at corporate level, various risks like credit risk, market risk or operational risk have to be converted into one composite measure. Therefore it is necessary that measurement of operational risk should be in tandem with other measurements of credit and market risk so that the requisite composite estimate can be worked out. So, regarding to international banking rule (Basel Committee Accords) and RBI guidelines the investigation of risk analysis and risk management in banking sector is being most important. In this context the following research question arises: Even though the risk is unavoidable can it be assessed properly and controlled? Are there any contingency plans to deal with risk if it occurs? How important is the study of risk management?

OBJECTIVES OF THE STUDY

- To understand the different types of risk faced by the Banks
- To Examine the process of Risk Management
- To find out the importance of Risk Management
- To analyse the contingency plans to deal with risk

TYPES OF RISK

Risk is defined as the possibility that an event will occur and adversely affect the achievement of objectives. The important types of risk applicable to the Banking Sector are

Credit Risk—Borrower or counter party will fail to meet its responsibilities according to the agreed terms.

Market Risk -- Risk due to the movement in market price. It includes loss due to fluctuations in interest rate or stock price or loss due to international currency exchange rate or loss due to fluctuations in agricultural, industrial and energy commodities.

Operational Risk – Risk of loss resulting from insufficient or unsuccessful internal processes, people and system or from external events.

Liquidity Risk – Risk arises due to the inability to meet its day to day cash transactions. It occurs when long term assets are funded by short term liabilities.

Reputational Risk—Probable loss of the organisation's reputational capital due to the activities conducted by the bank, rumors about the bank, willing or unconscious noncompliance with regulation, data manipulation, bad customer service etc.
Business Risk—Possibility that a company is not able to perform according to the expectation.
Systematic Risk -- Risk that does not affect a single bank but affects the whole industry.
Moral Hazard Risk—Risk which occurs when a big bank or large financial institution takes risk knowing that someone else will have to face the burden of those risk.

PROCESS OF RISK MANAGEMENT

Credit Risk Management is a significant factor which determines the survival, growth and profitability of the bank. As Lending is the primary function of the bank, it is generally encouraged whereby funds being transferred from the system to productive purpose which results in economic growth. Credit risk management is defined as the process of identifying, measuring, assessing, monitoring and controlling credit risk (Basel committee 2000)
Risk Management Process includes the following
Risk Identification-- understanding the nature of different kinds of risk, the various situations which can lead to risk and the reasons for the risk.
Risk Assessment and Measurement-- systematic process for recognizing and appraising events
(Possible risks and opportunities) that could affect the achievement of objectives positively or negatively.
Risk Control—Risk mitigation through control techniques, deputation of competent officers to deal with risks.
Risk Monitoring—Supervise the risk on a regular basis. The banks have to develop the parameters on which the transactions are to be tested to ensure that no risk to viable survival of the financial component or investment of the bank.
Risk Return Trade off -- The organization has to have a proper balancing of risk against earnings.

CONCLUSION

Risk is an opportunity as well as a threat. The Banking industry is exposed to different types of risk. The existence of an organization depends heavily on its competences to forecast and prepare for the change rather than just waiting for the change to happen and react to it. The essence of risk management is not avoiding or eliminating risk but deciding which risk to exploit and which one to avoid or hedge. Risk management covers risk identification, assessment, measurement, monitoring and controlling all risks inherent in banking business. It is very important for the organization to have a Risk Management Committee, Credit Policy committee and Asset Liability committee to anticipate adverse changes and take the precautionary measures well in advance. Another important aspect is that credit appraisal done by the concerned members on behalf of the institution should report their reviews to the higher authorities and others also should measure, monitor and evaluate the risk. Internal Rating System and Risk adjusted rate of return on capital are to be followed. Banks should assess credit worthiness before sanctioning loans by following credit rating techniques. Regular Evaluation and Rating system, Maximum limit exposure for single or group borrowers, Alertness on the part of operating staff at all stages of operations including post sanction follow up can reduce the risk to a great extent. It is very vital for the banks to ensure that they have adequate capital to support all the probable risks in their business. It can be concluded that the success of the organization will be depending upon how efficiently the enterprise takes care of the entire risk management system. It ensures that the risks are consciously taken with full knowledge, clear purpose and understanding -so that it can be measured and mitigated.

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